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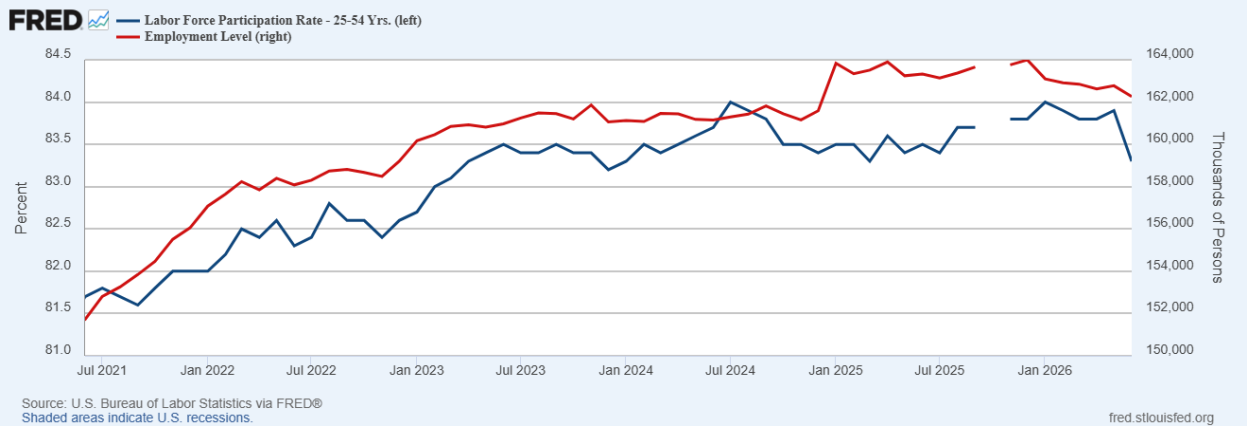
The Labor Market, Not Inflation, is the Bigger Risk

Last month, we changed our base case from a mild U.S. recession to slow growth over the next year. The June employment report, however, was a major disappointment following two months of better labor market data, including the exceptional May report. It serves as a stark reminder **that higher unemployment is a much bigger risk than persistent inflation**.

Employment reports are two separate surveys; a larger survey of businesses and a smaller sampling of households. The business survey was reminiscent of 2025 through April 2026, when private education and healthcare accounted for all job growth. These sectors grew by 69,000 in June, while the rest of the economy contracted by 12,000. This is bad news because education and healthcare tend to be insensitive to the business cycle and are not predictive of what is to come. These figures are a reality check that the labor market is still fragile.

While the firm survey was weak, **the household survey was so terrible that we believe that it is *partly* an outlier**. The drop in the unemployment rate from 4.3% to 4.2% is irrelevant. Prime-age labor force participation (25-54 years old) plummeted from 83.9% to 83.3%. Excluding covid-19, this is the biggest monthly decline since 1968. We reiterate that the household survey is noisy on a month-to-month basis. Figure 1, however, shows concerning trends in both labor force participation (blue) and overall employment (red) dating back to January.

Figure 1: Prime Age Labor Force Participation (blue) and Employment (blue)



Through 1Q2026, U.S. GDP growth had significantly outperformed the labor market. The Atlanta Fed's public model, however, now shows 1.4% GDP growth in 2Q2026, which continues to be boosted by very strong AI-based business investment that will not boost the labor market. GDP and employment are finally coming into closer alignment. **We expect this slow, but positive, growth to last for the next year along with weak job growth.** It reflects an economy that is close to normal, except that interest rates are restrictive due to a combination of tight monetary policy and long-term yields that are inflated due to overrated inflation concerns.

Other Developments in Macroeconomics:

1. **Despite the poor employment data, we are holding the risk of a U.S. recession within the next year steady at a still elevated 35**%. This is partly because of the New York Fed's new consumer survey. This survey itself is a mixed bag. It does show, for example, that households' inflationary expectations have risen, with the 5-year ahead forecast up from 3.1% to 3.4% in June. We are not too worried about this jump, and **our conviction remains that inflationary readings will cool off by the fall**, especially if this week's jump in crude oil prices is short-lived. Furthermore, we put much more weight on business expectations of inflation which remain in decent shape. Households did, however, become more optimistic about the labor market, reporting less concern with losing their job and more confidence that they could find another. Given that the weakness in the employment data is centered around the household survey, this is reassuring.

2. The June FOMC minutes did little to change our outlook, but they do shed light on why the Fed is placing so much weight on inflation. The minutes cite "strong AI-related demand, the conflict in the Middle East, or the effects of tariffs" as factors that could keep inflation elevated longer than expected so that "some policy firming would likely be warranted." We disagree with all three. Tariffs were inflationary into early 2026, but for their impact to continue, there would have to be even higher tariffs. **Likewise, while this week's escalation with Iran does create some inflationary risk, energy prices are now well below peak, which will soon be disinflationary**. Finally, it is true that AI-driven business investment is inflationary. This impact is, however, modest. Down the road, it should also lead to faster productivity growth which will be disinflationary. The minutes did show that the FOMC is aware that falling shelter inflation will bring down upcoming inflation readings. This observation did not, however, appear to affect their discussion of upcoming policy decisions.

3. Following oral argument in the U.S. Supreme Court, we expected Fed Governor Lisa Cook to easily win in *Trump v Cook.* We were thus surprised that her victory was only by a narrow 5-4 margin. **Although we agree with President Trump's basic position that the FOMC should lean toward lower rates, the U.S. economy dodged a major bullet with the decision**. A Trump victory would have led to much worse monetary policy down the road and higher term premiums in the near-term. Following the ruling, markets have understandably mostly ignored Trump's latest salvo against the FOMC where he called it "a little bit hostile." Between the court's decision and Chairman Warsh's clear inclination to disregard his own statements prior to his nomination, **Trump has lost any ability to manipulate the Fed for the rest of his presidency.**

-Paul Shea

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